

# ANALYSIS OF ORIGINAL BILL

## Franchise Tax Board

Author: Nation Analyst: Kimberly Pantoja Bill Number: AB 26  
Related Bills: See Legislative History Telephone: 845-4786 Introduced Date: 12/04/2000  
Attorney: Patrick Kusiak Sponsor: \_\_\_\_\_

**SUBJECT:** Scholarshare Trust Refundable Credit/FTB Report To Legislature Annually Regarding Utilization of Credit

### SUMMARY

This bill would establish a refundable tax credit of up to \$500 for contributions to Scholarshare accounts.

This bill also would require the department to prepare a report annually on the utilization of the credit.

### PURPOSE OF THE BILL

According to the author's staff, the intent of the bill is to provide a state tax incentive to encourage families to save for their children's college education through the Scholarshare Program.

### EFFECTIVE DATE

As a tax levy, this bill would be effective upon enactment and operative for any contribution made on or after January 1, 2001, and before January 1, 2006.

### LEGISLATIVE HISTORY

Federal Public Law 104-188 (1996), amended by Public Law 105-34 (1997), established an exemption from federal taxation for certain qualified state tuition programs (such as Scholarshare) with tax-deferred treatment of the earnings on contributions made to a qualified state tuition program.

AB 530, Committee on Higher Education, (Stats. 1997, Ch. 851) established the California Golden State Scholarshare program, which, in conformity with the federal qualified state tuition criteria, provided an exemption from state taxation for the Scholarshare program and tax deferred treatment of the earnings on contributions made to the Scholarshare program.

AB 2797, Machado, (Stats. 1998, Ch. 322) allows, by direct conformity to federal provisions, an exemption from state taxation of other states' qualified state tuition programs and tax deferred treatment of the earnings on contributions made to any other state's qualified state tuition program.

SB 1262, O'Connell, (Stats. 1999, Ch. 664) made a number of technical changes to the California Golden State Scholarshare program under the Education Code, including making the Scholarshare Investment Board, which is chaired by the state Treasurer, responsible for administering the program instead of the Student Aid Commission.

#### Board Position:

_____ S	_____ NA	_____ NP
_____ SA	_____ O	_____ NAR
_____ N	_____ OUA	_____ X PENDING

#### Department Director

#### Date

Gerald H. Goldberg

03/06/01

AB 2095, Lempert, (2000), with the same language contained in this bill, died in the Assembly Revenue and Taxation Committee; SB 44, Alpert, (2001), with similar language as contained in this bill, is currently in the Senate Revenue and Taxation Committee.

## **PROGRAM HISTORY/BACKGROUND**

Under the Golden State Scholarshare Trust, participants open an account on behalf of a designated beneficiary. The money contributed to the account is placed in a trust that will invest in special investment portfolios chosen by the participant, which are designed to meet the needs of differently aged beneficiaries and different kinds of investors. The program is designed so that earnings in a Scholarshare Account will grow on both a federal and a state tax-deferred basis until the beneficiary is ready to go to college. The funds in the account can be used to pay for qualified higher education expenses at any eligible post-secondary institution throughout the U.S. (and even some outside the U.S.) - including vocational schools.

The Scholarshare program offers four different ways for a participant to choose to invest their contributions. Three involve investments in a combination of stock, bond, and money market mutual funds. Although investment returns for the equity-based options will fluctuate and are not guaranteed since the value of accounts invested in these options will go up and down. The fourth option allocates contributions to a guaranteed funding agreement that guarantees the Scholarshare Trust both a return of principal and a fixed minimum rate of return.

## **SPECIFIC FINDINGS**

**Existing federal law** provides that distributions and earnings from a state tuition program are nontaxable for the taxpayer if the account meets the following criteria:

- A. Established and maintained by a state agency or instrumentality under which a person may purchase tuition credits for a designated beneficiary or make contributions to an account established to meet the qualified higher education costs of a designated beneficiary;
- B. Purchases or contributions may be made only in cash;
- C. A penalty, which is more than de minimis, is imposed on any refund of earnings from the account that is not:
  - 1. used for qualified higher education expenses of the designated beneficiary;
  - 2. made on account of the death or disability of the designated beneficiary; or
  - 3. made on account of a scholarship received by the designated beneficiary to the extent the refund does not exceed the amount of the scholarship used for qualified higher education expenses;
- D. Provides separate accounting for each designated beneficiary;
- E. Provides that contributors and beneficiaries may not, directly or indirectly, dictate the investment of any contribution to the program or earnings thereon;
- F. Does not allow interest in the program to be used as security for a loan;
- G. Prohibits contributions in excess of that necessary to provide for the qualified higher education expenses of the beneficiary, which are defined as tuition, fees, books, supplies, and equipment and reasonable costs for certain room and board; and
- H. Provides for program reporting to the Internal Revenue Service (IRS) of distributions and educational benefits received.

This **federal law** provides that the gross income of the contributor does not include earnings (at the time they are earned) under the program, and the gross income of the beneficiary does not include contributions to or earnings (at the time they are earned) under the program. However, distributions from the program in excess of amounts contributed (such as interest or dividend earnings) would be included in the gross income of the designated beneficiary at the time the distributions are made. The furnishing of education to a designated beneficiary is considered a distribution. The California Golden State Scholarshare program (discussed below) meets the criteria listed above; therefore, participants in the state Scholarshare program receive these federal tax benefits.

**Existing state law in the Education Code** established the Golden State Scholarshare Trust. The Scholarshare Investment Board may enter into participation agreements with participants to make payments to the trust for the payment of qualified higher education expenses for a designated beneficiary to attend an institution of higher education. The program establishes an overall maximum investment level for a designated beneficiary equal to the maximum estimated qualified higher education expenses, as defined, that can be incurred by a beneficiary to obtain a baccalaureate degree at an institution of higher education in California in four years. A penalty is imposed if a participation agreement is canceled for reasons other than death or disability of the beneficiary or in the event the beneficiary receives a scholarship. Pursuant to the participation agreement, the commission invests the pooled trust moneys and any earnings are used by the state to make payments to institutions of higher education on behalf of beneficiaries and to pay for administration costs. The Scholarshare Investment Board is required to adopt regulations to implement the Scholarshare program that are consistent with the requirements for exclusion or deferral from federal taxation. The trust is required to provide an annual listing to the department of all Scholarshare distributions.

**Existing state law** provides an exclusion from the gross income of a designated beneficiary for contributions to the California Golden State Scholarshare program and tax-deferred treatment for earnings on those contributions to the California Golden State Scholarshare program, which approximates the federal law, by: (1) deferring from current taxation to the participant or beneficiary earnings from the trust at the time they are earned; (2) providing that distributions from the program in excess of amounts contributed (such as interest, dividends, or capital gains) would be included in the gross income of the designated beneficiary at the time the distributions are made; and (3) providing that the furnishing of education to a designated beneficiary is considered a distribution.

**Existing state law**, through direct conformity to the federal qualified state tuition program, provides the same tax exclusion and tax deferred treatment to California taxpayers who participate in any other state's qualified state tuition program.

**Neither federal nor state laws** currently allow a credit for contributions to the state Scholarshare program or other qualified state tuition programs.

**This bill** would extend the incentive to save for education by allowing individuals a refundable credit for contributions to a Scholarshare trust made on behalf of any qualified beneficiary. The credit amount would equal a specified percentage of the amount contributed, determined by the taxpayer's filing status and adjusted gross income (AGI), not to exceed \$500 per qualified beneficiary. "Qualified beneficiary" would include only those individuals who have been designated in a participation agreement under the Scholarshare program.

**This bill** would specify that no credit will be allowed for contributions when the beneficiary's Scholarshare account equals or exceeds the maximum investment level established under the Scholarshare program.

**This bill** would provide that the entire amount of credits claimed in prior years would be recaptured the year of cancellation if the participation agreement is canceled or in the year of withdrawal if a withdrawal is not used for qualified higher education expenses.

**This bill** specifies that any credit in excess of the taxpayer's tax liability would first be credited against other amounts due, and the balance, upon appropriation by the Legislature, would be refunded to the taxpayer.

**This bill** would require the Scholarshare Investment Board to report to the department several items regarding annual contributions and earnings. **The bill** also would require the department to report annually, to the extent data is available, on the utilization of the credit allowed under the bill.

#### Policy Considerations

Historically, refundable credits such as the prior state renter's credit and the federal Earned Income Credit have had significant problems with invalid and fraudulent returns. These problems are aggravated if a refund is made that is later determined to be fraudulent, the refund commonly cannot be recovered. However, fraud concerns are reduced with this credit due to the narrow criteria when claiming the credit and the requirement that the department would be provided a tape by the Scholarshare program that will enable the department to verify beneficiaries and claimants.

#### Implementation Considerations

This bill would require an appropriation of money by the Legislature to pay refunds resulting from this credit. Disallowance of the credit to some taxpayers could result if the amount of credits claimed exceed the funds appropriated. If sufficient funds are not appropriated to cover all of the refunds due, this would result in payments of additional interest to refund recipients and would likely result in additional telephone calls inquiring about delayed refunds, increasing departmental costs.

#### Technical Considerations

The bill uses both the term "individual" and "taxpayer" in the same subdivision. For simplicity, Amendment 1 has been provided so that only the term "individual" is used.

The bill defines the term "qualified beneficiary" by reference to the Education Code. However, the Education Code only uses the term "beneficiary." Amendment 2 is provided to make the terms consistent.

### **LEGISLATIVELY MANDATED REPORTS**

This bill would require FTB to report to the Legislature annually, to the extent data is available, on the utilization of the credit.

## **FISCAL IMPACT**

### Departmental Costs

The department's costs to administer this bill are estimated to be \$356,000, which includes one time implementation costs of \$212,000, for fiscal year 2001-02 and would increase each year as volumes increase to a maximum of \$261,000 in 2005. It is estimated that this bill would require the department to incur four additional personnel years (PYs) in 2001-02, increasing to a total of six PYs in 2005-06. Amendments 3 and 4 are provided to suggest language for an appropriation to fund these departmental costs.

The costs were calculated using the following assumptions:

- The population of taxpayers expected to claim the credit would start at 37,000 in 2001-02 and increase to approximately 180,000 in 2005-06.
- All filers claiming this credit are assumed to be taxpayers who currently file a return. It is not anticipated that this credit would encourage persons who do not currently file a return to file solely to claim the credit.

### Tax Revenue Estimate

Based on limited data and assumptions discussed below, this bill would result in the following revenue losses under the PITL.

Estimated Revenue Impact of AB 26 As Introduced 12/4/00 [\$ In Millions]		
2001-02	2002-03	2003-04
-\$4	-\$9	-\$14

The bill would be effective for contributions made on or after January 1, 2001, and before January 1, 2006, with enactment assumed after June 30 of this year. Except for specific AGI classes and credit percentages, it is assumed other credit limitations apply on a per beneficiary basis.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

### Tax Revenue Discussion

The revenue impact of this bill would be determined by the amount of credits generated and reported on tax returns.

The estimate was developed by (1) projecting separately the number of existing accounts at the beginning of each year and the number of new accounts opened during the year, (2) determining how accounts would be distributed by filing status and AGI class of eligible taxpayers, (3) estimating levels of contributions by adjusted gross income (AGI) class, (4) calculating an average credit for contributors by filing status and AGI class, (5) summing credits generated for all groups, and (6) adjusting for (a) any individual making a contribution on behalf of any qualified beneficiary and (b) the rate at which taxpayers claim the proposed credit on tax returns.

Liability year estimates were converted to cash-flow estimates in the table above. Cash-flow estimates reflect the ability of some taxpayers to accelerate tax benefits by adjusting their estimated tax payments.

The launch date for the Golden State Scholarshare program was October 4, 1999. As of January 1, 2001, the number of Scholarshare accounts was approximately 27,000. Numbers of accounts qualifying for the proposed credit are projected at 45,800, 76,100, 114,100, 155,800, and 195,100 by year-end 2001 through 2005. Projections assume a certain rate of normal program growth each year. It is assumed that the incentive effect of the proposed tax credit would generate additional new accounts rather than materially increasing the level of contributions to existing accounts. Therefore, an additional rate of growth is applied to reflect an increase in accounts initiated each year by individuals who would qualify for the credit.

Tax return data were used to distribute projected accounts for qualified beneficiaries by filing status and AGI class of contributing taxpayers. Contributions would be sensitive to income levels of participating taxpayers. Average contributions were estimated at a certain percentage of the mid-point AGI for AGI classes specified in the bill. Percentages ranged from 1% for the lowest AGI class to 2.25% for the highest. For accounts initiated during a year, contributions were assumed to begin mid-year.

Average contributions were multiplied by a specified credit percentage (depending upon AGI) to derive an average credit for both existing and new accounts by filing status and AGI class. Average credit amounts are grown from one year to the next by 3% to represent future growth in the income of eligible taxpayers.

Credits for all groups were summed. Total credits were increased an additional 5% to account for any individual making a contribution on behalf of any qualified beneficiary. Finally, allowances were made for the percentage of credits that would actually be reported on tax returns.

## **BOARD POSITION**

Pending.

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FRANCHISE TAX BOARD'S  
PROPOSED AMENDMENTS TO AB 26  
As Introduced December 4, 2000

AMENDMENT 1

On page 2, line 5, strike "a taxpayer" and insert:  
that individual

AMENDMENT 2

On page 3, strike lines 1 through 3 and insert:

(c) For purposes of this section, "qualified beneficiary" has the same meaning as "beneficiary" as provided in subdivision (c) of Section 69980 of the Education Code.

AMENDMENT 3

On page 4, between lines 2 and 3 insert:

SEC. 2. (a) There is hereby appropriated from the General Fund for expenditure in the 2001-2002 fiscal year the sum of three hundred fifty six thousand dollars (\$356,000) for allocation to the Franchise Tax Board in augmentation of Item 1730-001-0001 of the Budget Act of 2001.

(b) Funds allocated pursuant to subdivision (a) shall be expended by the Franchise Tax Board solely for the purposes of implementation and administration of the Scholarshare Trust Refundable Credit.

SEC. 3. This act makes an appropriation for the usual current expenses of the state within the meaning of Article IV of the Constitution and shall go into immediate effect.

AMENDMENT 4

On page 4, line 3, strike "SEC. 2." and insert:

SEC. 4